National Rural Electric Cooperative Association
A Touchstone Energy® Cooperative

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Chief Executive Officer

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Mr. Blaine D. Stockton
Assistant Administrator
Electric Program
U.S. Department of Agriculture, Rural Utilities Service
Room 5156 South Building, Stop 1560
1400 Independence Avenue, S.W.
Washington, DC 20250-1560

RE: Proposed Rule, 7 CFR Part 1720, Guarantees for Bonds and Notes Issued for Electrification and Telephone Purposes

Dear Mr. Stockton:

The National Rural Electric Cooperative Association (NRECA) files these comments to the proposed rule of the Rural Utilities Services of the Department of Agriculture, published on December 30, 2003, which would add *Rule 7CFR Part 1720, Guarantees for Bonds and Notes Issued for Electrification and Telephone Purposes* (68 Fed. Reg. 75154, December 30, 2003). The proposed regulation is intended to implement section 6101 of the Farm Security and Rural Investment Act of 2002 (Pub, L. 107-171, 116 stat 413) (FSRIA), which added new section 313A of the Rural Electrification Act, *Guarantees for Bonds and Notes Issued for Electrification or Telephone Purposes* (7 USC 940c-1).

NRECA is the national service organization representing rural electric cooperative utilities. NRECA represents 930 not-for-profit cooperative utilities. The National Rural Utilities Cooperative Finance Corporation (CFC), one of two electric and telephone cooperative lenders eligible for guarantees under the program authorized under section 313A of the Rural Electrification Act (RE Act) (Section 313A), is a member of the NRECA[1]. Many of NRECA electric and telephone cooperative members are eligible for loans under the RE Act and are eligible for rural development loans and grants under section 313(b) of the RE Act (7 USC 940c(b)) -- the Rural Economic Development Loan and Grant (REDLG) program. The REDLG Program has provided more than 1000 rural economic development interest-free loans and grants to 335 electric cooperative members of the NRECA. NRECA and its membership are vitally interested in the appropriate implementation of Section 313A, in accordance with Congressional intent, and adequate, consistent funding of the REDLG program.

[1] CoBank, a Government Sponsored Enterprise (GSE), is the other eligible lender under this program. CoBank has indicated to NRECA that given the interest rate spreads in today's markets, CoBank would not find this program to be economically workable, especially considering the restrictions and controls proposed in this rulemaking. NRECA's comments are, therefore, largely confined to CFC.

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REDLG Program Has Brought Needed Development Funds to Rural America

Over the years, the REDLG program has provided over $250 million in loans and grants to rural electric cooperatives to be used for economic development grants and low-interest loans. The electric cooperatives have been able to leverage the REDLG funds, through matching grants and other supplemental funding, to bring more than $1.4 billion in economic development assistance to rural America.

REDLG funds build fire stations, buy emergency equipment and vehicles, improve health care centers, and build or increase local manufacturing capabilities. The REDLG funds help create much-needed jobs that keep rural communities vibrant and quality places to live. Some examples of the community development successes achieved under the REDLG program are described in Attachment A.

New Program's Potential is Jeopardized by Unauthorized Requirements in Proposed Rules

In the Notice of Proposed Rulemaking, the RUS estimates that the proposed regulation would generate $90 million of investment capital for the REDLG. NRECA conservatively estimates that the guarantee fees charged under the program could result in $250 million in new grants or in excess of $1 billion in new loans. In addition, based on considerable past experience in the REDLG program, these funds have the potential to leverage private funds at nearly six time the program investment. This new investment in rural development comes at no or extremely low cost to the government.[2] However, the proposed regulation contains onerous provisions, not authorized under Section 313A, that would render the guarantee program unworkable for CFC. The end result will be that REDLG receives no funds under the guarantee program.

NRECA principally objects to three provisions in the proposal that would impose capital requirements and restrictions on the guarantee that are not authorized in Section 313A: (1) the imposition on eligible lenders of capital requirements under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) (designed for FDIC-insured banks and savings and loans) that, because of a cooperative lender's equity structure, would make CFC ineligible for a guarantee; (2) the arbitrary requirement that a lender only return 5% of eligible patronage capital to its cooperative members, during the term of the guarantee; and (3) the imposition of a 15-year limit on the bonds or notes guaranteed. Additionally, other limitations, also without a statutory basis, could significantly reduce the economic benefits of the government guarantee, namely: (1) the creation of a bankruptcy-remote trust; (2) limiting the program to secured notes and bonds; and (3) the requirement that the bonds or notes be issued to the Federal Financing Bank.

[2] Section 313A has consistently received low/no cost budgetary scores. The Secretary acknowledges that the program carries only minimal risk to the government. (68 Fed. Reg. 75153, 75156).

<u>Background</u>

Section 313A

Section 313A establishes an RUS guarantee program that provides a new source of private funding for rural economic development projects sponsored by electric and telephone cooperatives. Under Section 313A, eligible lenders pay an annual fee for an RUS guarantee of notes or bonds used to fund loans that are made for any electrification or telephone purpose under the RE Act. The annual fee is 30 basis points of the unpaid amount of the bond or note. The fee is deposited in the REDLG sub account and used to fund the REDLG program. Up to one-third of the fees can be used by the Secretary of Agriculture to pay the subsidy cost of providing the guarantee, if needed.

Section 313A authorizes guarantees to a particular lender in an amount not to exceed the principal balance of all outstanding loans of the lender that have been made concurrently with the RUS under the RE Act. When Congress annually sets the limits of the concurrent loan program under Section 307 of the RE Act, it also sets the limits on this guarantee program.

These provisions along with other strong, specific taxpayer protections will maintain the guarantee program as a "zero-cost," low-risk program, while creating a steady stream of funds to the REDLG program.

Statutory Criteria for the Loan Guarantees

Section 313A (a) provides that subject to qualifications and limitations provided in subsection (b), "the Secretary ***shall*** guarantee payments on bonds or notes issued by a ***cooperative*** or other lender organized on a not-for-profit basis if the proceeds of the bonds or notes are used to make loans for an electrification or telephone purpose…." (Emphasis added.)

Subsection (b) establishes four types of limitations for the program: (1) a cap on the aggregate amount of guarantees issued on behalf of an eligible lender; (2) a prohibition against using the underlying loans proceeds for the generation of electricity; (3) qualifications for eligible lenders; and (4) a prohibition against using the savings generated by a guarantee to lower the interest rates on loans other than concurrent loans, as provided in section 307 of the RE Act.

Section 313A(b)(3) gives the Secretary discretion to deny a request for a guarantee under only three circumstances. First, the eligible lender does not have appropriate expertise or experience or is otherwise not qualified to make loans for electrification or telephone purposes. Second, the bond or note issued by the lender would not be investment grade quality without a guarantee. Or, third, the lender has not provided the Secretary a list of loan amounts for the underlying loans that the lender certifies are for eligible purposes.

Nothing in Section 313A suggests that the Secretary has the authority to limit the guarantee to a 15-year period. On the contrary, subsection (a) states that the Secretary shall guarantee any note or debt fitting the criteria and qualifications of the statute. The Secretary can limit the number of guarantees issued in any single year to five, in order to insure she has adequate administrative resources to examine proposed guarantees.

Issues

Capital Adequacy and the FIRREA Capital Standards

Congress first laid out the FIRREA capital requirements in 1989 during the tumultuous days of the collapse of the savings and loan industry and the most severe banking crisis since the Great Depression. In 1991, Congress made these requirements more stringent with the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and its prompt corrective action requirements. In establishing this capital regime for FDIC-insured institutions, Congress sought to provide uniform capital standards, applicable to both banks and savings associations, and to end or curtail the practice of regulatory forbearance, which allowed many depository institutions to remain open long after they were insolvent by almost any measure. The capital requirements were seen as strengthening what was already a very comprehensive, but faulty, regulatory scheme for federally insured depository institutions. Congress did not intend to create capital standards for all unregulated private financial institutions.

Section 313A does not authorize the Secretary to impose on eligible lenders the capital adequacy standards applicable to FDIC-insured depository institutions and the comprehensive regulatory scheme used to enforce those standards. Instead, Section 313A calls for a market-based determination of capital adequacy. To qualify for a guarantee, Section 313A(b)(3)(B) requires only that the bond or note to be guaranteed be of investment grade quality.

Achieving investment grade quality is the only financial criterion called for in the statute. To achieve and maintain an investment grade, an issuer must be financially sound, including having adequate capital. The level of capital and the financial strength of a company are determined by the credit rating agencies and the financial markets. This market-determined capital adequacy criterion is appropriate for this loan guarantee program, which, as the Secretary acknowledges, carries minimal risk to the government. (68 Fed. Reg. 75153, 75156).

Moreover, FIRREA's capital standards as adopted by Congress and interpreted by the federal banking agencies, are not compatible with the capital and organizational structure of CFC. By all measures, CFC is a well-managed and well-capitalized lender. It has consistently achieved strong investment grade ratings s from the credit rating agencies. However, it is a cooperative, owned by its borrowers. It does not issue stock. Members' Subordinated Certificates purchased by CFC members are the major source of its equity capital. These certificates are of quite long maturities with some not maturing until 2095.

The FIRREA capital standards and the prompt corrective action provisions, adopted in FDICIA, apply to shareholder-owned banks and savings associations and mutual savings associations. It was never anticipated that they would apply to a cooperative lender such as CFC. Capital term certificates, such as those held by CFC's members, would not qualify as capital under the regulations implementing FIRREA. See, e.g. 12 CFR §§567.1 et seq., .[3] As a result, CFC would not meet the adequately capitalized standards under the banking agencies prompt corrective action regulations, notwithstanding the fact that the credit rating agencies and the financial markets consider CFC to be a well-capitalized and well-run lender. See, 12 CFR § 565.4.

In summary, the imposition of FIRREA capital standards on qualified lenders is inappropriate. Section 313A imposes only one financial qualification on a qualified lender – investment grade ratings on the lender's bonds or notes. Investment grade ratings can only be achieved by firms that are well-managed and financially sound, including having adequate capital. FIRREA's capital standard were never intended to apply to a cooperative lender. FIRREA implementing regulations would not recognize subordinated capital term certificates as capital. As a result, CFC, one of the eligible lenders under the statute, would not qualify for a loan guarantee, if these regulations were to be implemented.

Cap on Patronage Capital Distributions

The proposed regulation would require that the eligible lender restrict its annual capital patronage distribution to five percent of the total patronage eligible. NRECA respectfully objects to this requirement.

Section 313A does not authorize the Secretary to establish such a requirement. Again, the only financial requirement under the legislation is an investment grade rating, which carries with it the market determination that a company is adequately capitalized and represents a low-risk of default. If a lender is to maintain its investment grade, it will have to maintain adequate levels of capital.

This cap on the pay out of patronage capital is arbitrary. A lender would be restricted in its distribution of patronage capital to its members, even if it were otherwise very well capitalized. Moreover, the proposal would impose a restriction on all patronage capital retirements of an eligible lender, despite the fact that only a relatively small portion of the capital of the cooperative lender was supported by such guarantees.

The cap will needlessly tie up the members' capital and increase their cost of borrowing. As a result, the cost of operating the rural electric cooperatives would increase, along with their rates.

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[3] CFC is technically not a mutual form of organization. It is organized and operates as a cooperative. Office of Thrift Supervision regulations are cited because some of the institutions supervised by OTS are mutual savings banks, which are the only non-stock institutions subject to FIRREA. However, they are not cooperatives and the regulations cited do not recognize the Capital Term Certificates as equity.

Most RUS borrowers are also members of CFC. The proposed cap, in effect, would reduce the cash flow of these RUS borrowers. It is important for these borrowers and RUS loan security with respect to loans made to these borrowers that CFC not be prohibited from continuing its own patronage return policy, while maintaining capital adequacy.

15-Year Limit on Guaranteed Bonds Increases Risk and Decreases Funds for Rural Development

Nothing in Section 313A authorizes the Secretary to limit the term of the guarantee to fifteen years. Section 313A(a) states that subject to subsection (b), the "Secretary shall guarantee payments on bonds or notes issued by a cooperative lender…." Subsection (b) does not permit the Secretary to limit the term of the bonds guaranteed.

Most loans for electric utility infrastructure entered into by RUS and CFC have a 30- or 35-year term. Certainly, the vast majority of loans in the concurrent loan program have 30- or 35-year terms.

CFC issues bonds with terms to match the underlying loans that the bonds will fund. Matching the terms of the bonds with the loans they fund is a prudent practice for any lender. Matched funding helps a lender reduce its liquidity and interest-rate risk. It is in the interest of the guarantor, as well as the lender, that the lender minimizes such risk.

Moreover, instead of receiving guarantee fees for 30 or 35 years, the REDLG program would only receive guarantee fees over the 15-year life of a bond. This would cut the program's economic development benefits to rural America in half.

Other Limitations Not Supported by the Statute

As we have noted, the statute contains only one financial criterion: the lender must have an investment grade rating. However, the proposed regulations would impose further restrictions that are not needed for a lender with an investment grade. These restrictions serve only to limit the value of the guarantee program to electric cooperatives.

Proposed section 1720.5 (c)(1) would require an eligible lender to establish a bankruptcy remote trust fund capitalized in the amount of 5% of the guaranteed amount outstanding. As long as an eligible lender maintains an investment grade, this requirement is unnecessary. It only serves to tie up assets of the lender that could be used to fund other loans to electric and telephone cooperatives or to reduce their cost of borrowing.

The proposed regulation appears to anticipate that the bonds to be guaranteed will be secured by specific loans in the eligible lenders portfolio. Nothing in Section 313A gives the Secretary the discretion to refuse to guarantee an otherwise eligible bond only because it is not secured. It is unnecessary to impose this restriction on a lender with an investment grade credit rating. Such a requirement is inconsistent with current market practices. Secured debt is the exception rather than the rule for financially sound borrowers. Only about 4% of all investment grade corporate bonds issued are secured. Proposed section 1720.5(b)(4) would require an eligible lender to offer its bonds to the Federal Financing Bank (FFB). Again, Section 313A does not give the Secretary the discretion to limit the lender to issuing bonds only to the FFB. In fact, the statute includes provisions specifying that these guarantees shall "be fully assignable and transferable." Such a provision contemplates that the guaranteed notes and bonds could be issued in private markets. Certainly, the FFB could offer an eligible lender attractive rates on the bonds. However, it may not offer better rates than the market. The regulations should give the lender the option of selling the bonds to the FFB or the market.

Responses to Questions

The notice of proposed rulemaking asks those filing comments to give consideration to a series of questions. The following are the NRECA's response to those questions.

1. **Is the preamble's description of the economic impact on rural America complete or are there other concerns with regard to the potential benefits for or costs to rural communities, lenders making use of the program or taxpayers?**

Section 313A has great potential to provide significant economic benefits to rural America at no cost and only a minimal risk to the government. A less restrictively designed program would benefit rural America by lowering the cost of electric and telephone cooperatives' non-RUS borrowing. The guarantee fees generated by the program would provide a valuable new source of capital for the REDLG program. However, the restrictions cited above, were they to be included in the final regulation, make it highly unlikely that CFC would be able to use the program.

If the FIRREA capital standards are retained, CFC would not qualify for the guarantee program. The cap on patronage capital distribution would not create an attractive guarantee program because it would increase the cost of borrowing for CFCs members and the cost of electricity for their customers.

The fifteen-year bond term restriction significantly reduces the potential benefits for the REDLG program. A program that guarantees bonds with a normal maturity would generate $250 million in new funds for REDLG, supplying $250 million in grants or $1 billion in loans. Historically, the program has leveraged private funds at nearly six times the program investment.

The other restrictions cited above add needlessly to the cost of the program reducing the likelihood that a cooperative lender would ever make application for a guarantee.

2. **Please comment on the risk sharing method (bankruptcy remote trust) and other methods to protect the guarantor's interest through collateralization.**

As noted above, Section 313A does not authorize the Secretary to impose the bankruptcy remote trust requirement on a cooperative lender with an investment grader rating. Likewise, the provision would not permit the Secretary to impose a collateralization requirement for an investment-rated lender. However, Section 313A is silent on what actions the Secretary can take if a lender were to lose its investment grade rating after the guarantee has been issued. At that point, it would be appropriate to consider imposing some sort of a bankruptcy remote trust or collateralization requirement. These requirements should be tailored to serve the interests of the guarantor, the lender and the communities served by rural electric and telephone cooperatives.

3. **Please comment on the use of FIRREA standards as a model and the use of FIRREA-like restrictions in the event of noncompliance. Please comment on whether the use of financial triggers is an effective mechanism for protecting the guarantor's interests.**

For the reason cited above, we do not believe that the use of FIRREA capital standards is appropriate. However, it is appropriate that the government expect that a lender be financially sound, including having adequate capital, at the time of approval of the guarantee and that the lender maintain financial soundness throughout the life of the guarantee. The statute contemplates a market-based mechanism for determining financial soundness, that is, an investment grade rating. If the lender were to fall below investment grade, it would be appropriate for this event to trigger requirements that protect the guarantor's interest, including the establishment of financial performance measures that are consistent with the cooperative lender model and its capital structure.

4. **Should the guarantee program limit the amount of refinancing to 25% of the amount guaranteed?**

NRECA would note that refinancing, just like new lending, reduces the cost of borrowing for rural electric and telephone cooperatives. The savings are returned to the cooperatives' consumer-owners through lower rates or lower cost of capital to enhance the utility systems. Section 313A does not give the Secretary authority to limit the amount of refinancing. The regulation should remain neutral on this issue to allow the cooperative lender and its utility system members flexibility to determine the best use for the benefits from the guarantee program.

5. **Does the mechanism of third-party monitors (paid for by the eligible lender) provide adequate protection of the guarantor's interest? Are other mechanisms available that present fewer conflicts of interest while relying primarily on qualified private sector monitors?**

NRECA believes the use of a separate entity to provide monitoring compliance with the terms of the guarantee is unnecessary given the existing monitoring done by the three independent rating agencies on CFC's credit quality and standards. In addition, CFC files detailed reports with the SEC. CFC is also subject to the independent audits of a major nationally known CPA firm and must meet the requirements set forth in the Sarbanes-Oxley Act. In addition, the concurrent RUS-CFC loan program is subject to annual oversight and control by Congress. RUS has long-standing experience in lending to the very same cooperatives who would obtain financing from a qualified lender that receives a guarantee under Section 313A. No outside party is likely to possess the range or depth of experience that RUS has with these loans. We believe that RUS is the appropriate party to be responsible for any desired reviews or monitoring. Any other approach would just add unnecessary expense without adding comparable value.

6. **Does the program envisioned by the rule adequately minimize the financial risks to taxpayers? If not, what changes should be made to best reduce the risk while still providing the kind of guarantee program envisioned by Congress?**

As noted, the Secretary states in the preamble to the proposed rule that loans to rural electric and telephone cooperatives carry minimal risk. The Secretary cites that there have only been ten write offs of debts in the RUS program since the 1930s. Similarly, CFC has experienced unrecoverable losses of $106 million out of $85 billion in loans and guarantees it has issued since its inception in 1969. Given the nature of the loans and the success of CFC, the Secretary is absolutely correct when she asserts in the preamble that the risks to the government are minimal. (68 Fed. Reg. 75153, 75156). However, as noted elsewhere in these comments, notwithstanding the extremely low risk to the government, the Secretary proposes to place on the program unnecessary requirements and limitations that will stifle the creation of a robust guarantee program that brings new money to the REDLG program. The program envisioned by the regulation is not the one envisioned by Congress. The proposed rule would give RUS banking agency-like regulatory powers over eligible lenders. Congress, on the other hand, envisioned a market-based approach for determining capital adequacy and financial strength. Congress did not give the Secretary the discretion to impose limitations on the guarantee that are outside the statute, such as limiting the guarantee to bonds with 15-year terms.

7. **Does the rule adequately ensure that the recipient's management and lending practices are sound, effective and minimize default risk?**

The primary indicator of the lender's lending practices is the investment grade rating that is required under the statute. Any degradation in management or lending practices would cause the credit rating agencies to take immediate action. Without an investment grade rating, CFC's member/owners would turn to other commercial lenders for capital or simply tap the capital markets directly on their own.

In addition, the guarantee would only provide funding for a small portion of CFC's portfolio – roughly 15%. The overwhelming majority of CFC's capital would be unsecured, private market debt that mandates maintenance of high ratings. And, the guarantees provided under the Section 313A program do not, in any way, diminish credit risk to CFC in the event of default by any cooperative.

We do not believe that it is logical to assert that the quality of a lender's underwriting practices may diminish if some of a lender's funding is guaranteed.

8. Is the accompanying economic analysis for this rule objective and does it provide a reasonable complete assessment of each significant cost and benefit of the rule?

The Economic Impact Section of the proposed regulations estimates the potential savings to a qualified lender using the government guarantee at 1.2% or 120 basis points. This estimate overstates the potential interest cost savings to a qualified lender, such as CFC. The proposed rule states a "mid investment grade" company would be able to issue long term debt at a rate of 200 basis points (2%) above comparable Treasuries. Presently, based on secondary market spreads, a lender with an A rating, could issue 10 year senior secured bonds at 85 basis points (0.85%) over Treasuries and could issue 30 year senior secured bonds at 105 basis points (1.05%) over comparable Treasuries. Assuming the cost of the government guaranteed bonds were 50 basis points over Treasuries and the user fee was 30 basis points, the actual savings on a 10-year bond for CFC would be only 5 basis points (0.05%) and the savings on a 30-year bond would be 35 basis points (0.35%).

Conclusion

We appreciate this opportunity to comment on the Proposed Rule to implement the important new program authorized by Section 313A. The implementation of the loan guarantee program must be consistent with Section 313A and be compatible with the structure of a cooperative lender. We hope to continue to work with the Department of Agriculture to develop a successful loan guarantee program that maximizes the program's potential benefits for rural electric cooperatives and the communities they serve.

Sincerely,

Glenn English
Chief Executive Officer

ATTACHMENT A
EXAMPLES OF REDLG SUCCESS STORIES

North Carolina's rural areas are better places to live thanks to REDLG's 12 grants and 17 loans administered through the 27 electric distribution co-ops. Since 1989, REDLG has improved the quality of life in rural North Carolina through business incubators, business expansion, community water systems, a rural medical center, industrial parks, and other initiatives. The grants helped create 817 jobs. Since RED grants enable cooperatives to start revolving loan funds, the dollars keep giving back to the community and continue to benefit the state's businesses and communities. The loans, totaling $4,623,000, enabled the co-ops to leverage an additional $22,602,000 to create or retain 1,324 jobs.

REDLG enabled the 501(c)(3) REED Fund, Inc. and the17 electric cooperative members of East River Electric Power, Inc. to enhance the quality of life in eastern South Dakota and western Minnesota. The fund, South Dakota's second largest development capital resource, provides financing for businesses, infrastructure and other improvements that enable rural communities to retain, develop and attract jobs. Since 1996, REDLG awarded cooperative REED members 24 grants totaling $5.6 million. These awards enabled REED members to make 101 loans totaling over $18 million that helped local communities address business, health and welfare needs. In conjunction with the funds from REED, total project investments exceed $100 million and account for more than 3,000 jobs. Projects include a farmer-owned ethanol plant, a hospital expansion, community fire protection and many others that make the communities better places to live.

Virtually saving a community when farming and mining declined, REDLG was the vehicle that Jackson Electric Cooperative (WI) used to establish the Jackson Electric Economic Development Corporation. The corporation generated a $480,000 revolving loan fund to assist developing the 76-acre Black River Falls Industrial Park. Serving 6,500 customers in rural, west central Wisconsin, Jackson Electric Cooperative initiated the revolving loan fund with a $400,000 REDL&G grant, providing the required $80,000 match. The loan fund now manages a $4 million portfolio, the result of additional funding from the National Rural Utility Cooperative Finance Corporation (CFC), the Rural Utility Service, Dairyland Power Cooperative (G&T), the state and others. The $4 million portfolio attracted additional investments of over $60 million and created more than 2,000 jobs in the park, an adjacent prison and in the surrounding area.